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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

/X/ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 1999

/ / TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER:
333-62797

BIRCH TELECOM, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	43-1766929
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)
2020 BALTIMORE AVENUE KANSAS CITY, MISSOURI (ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)	64108 (ZIP CODE)

Registrant's telephone number, including area code:

(816) 300-3000

Securities registered pursuant to Section 12(b) of the Act:	Securities registered pursuant to Section12(g) of the Act:
14% senior notes due 2008 (Title of Class)	None (Title of Class)

Indicate by check mark whether the Registrant (i) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (ii) has been subject to such filing requirements for the past 90 days. Yes /X/ No / /

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. /X/

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. There were 4,781,101 shares of common stock, $.001 par value, outstanding as of March 23, 2000.

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PART I

THIS FORM 10-K CONTAINS CERTAIN FORWARD-LOOKING STATEMENTS THAT INVOLVE RISKS AND UNCERTAINTIES. OUR ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THESE FORWARD-LOOKING STATEMENTS AS A RESULT OF CERTAIN FACTORS, INCLUDING THOSE SET FORTH UNDER THE CAPTION "BUSINESS--RISK FACTORS" AND ELSEWHERE IN THIS FORM 10-K. UNLESS THE CONTEXT SUGGESTS OTHERWISE, REFERENCES IN THIS FORM 10-K TO "WE," THE "COMPANY" OR "BIRCH" MEAN BIRCH TELECOM, INC. AND ITS WHOLLY-OWNED SUBSIDIARIES.

ITEM 1. BUSINESS

OVERVIEW

We are a rapidly growing integrated communications provider. We seek to become the leading provider of telecommunications services for small and mid-sized businesses in each of the cities we serve. We offer state-of-the-art telecommunications services to our customers, who today are located throughout Missouri, Kansas and Texas. These voice and data service offerings include local and long distance telephone service, Internet access, web hosting, integrated voice and data transmission over broadband lines and customer premises equipment sales and services. We offer these services to our customers through a combination of leased and owned network facilities. We are currently deploying collocations and transmission equipment throughout our markets to deliver digital subscriber line service, which will support dedicated high-speed Internet access and eventually voice services. We expect to have over 130 collocations operational by the end of this year. Our revenue for the year ended December 31, 1999 was $60.5 million, a 132% increase over 1998.

BUSINESS STRATEGY

We believe that our business is poised for rapid expansion and that our experienced management team is well prepared to execute our focused business strategy. The key elements of our strategy include:

FOCUSING ON SMALL AND MID-SIZED BUSINESS CUSTOMERS

We focus on meeting the needs of small and mid-sized businesses in each of the cities we serve. Our tailored service offerings, direct sales model, and proactive customer service approach allow us to differentiate ourselves and achieve significant penetration into this very large, established customer base. We believe small and mid-sized businesses have not received a satisfying level of attention from the incumbent telephone companies, are unaware of their telecommunications network options and value our consultative, direct sales approach.

PROVIDING COMPLETE SERVICE PACKAGES THAT ARE TAILORED TO OUR CUSTOMERS

Our service offerings are specifically designed for the needs of our target customers. We provide simplified, feature-rich packages of services, superior value and a single source for all of our customers' networking requirements, all conveniently billed on a single invoice. Our service offerings include features offered in packages that we believe are not generally available from other providers. Our packages are priced to offer

savings of 10% to 40% from comparable services provided by the incumbent telephone company. Our direct sales representatives consult with our customers in person and assist them in selecting service packages appropriate for their needs.

CREATING A STRONG BRAND PRESENCE

We have quickly achieved a high level of brand awareness in our markets through an aggressive multi-media advertising campaign targeted at the incumbent telephone company. Our marketing efforts include billboard, radio and print advertising, as well as sponsorship of major local events, affiliations with local organizations and direct mailings. We believe we have been able to achieve a higher level of brand awareness in our markets than any other new market entrants. We plan to use our proven marketing and advertising strategy to help us achieve rapid and deep penetration in each new market we enter.

DEPLOYING A DIRECT SALES FORCE IN EACH OF OUR MARKETS

We deploy a large locally-based sales force focused on achieving a significant market share in each of our markets. We believe that our extensively marketed brand name, visible local presence, readily available services and emphasis on personal customer service have enabled our 170-person sales force to achieve high levels of productivity and quickly penetrate new markets.

INVESTING IN INDUSTRY-LEADING, SCALABLE BACK OFFICE SYSTEMS

We believe our state-of-the-art billing and operating systems are capable of supporting a significant number of lines. These systems, which include Saville Convergent Billing Platform-TM-, MetaSolv Telecom Business Solution-TM- and Harris Network Management-TM-, have already withstood the test of high volumes and rapid growth within our operation. Over the past year, we have expanded our provisioning capacity from 3,000 lines per month to nearly 15,000 lines per month and believe that our existing infrastructure can support continued capacity increases.

MAINTAINING MAXIMUM NETWORK FLEXIBILITY

- INTEGRATING DATA AND VOICE NETWORK SERVICES. By integrating both data and voice services, we believe we will be able to deliver a broadband digital subscriber line connection to a significant percentage of our customers. We believe this integration will yield bandwidth flexibility to our customers and the strategic advantage of an improved product with reduced monthly costs.

- CAPITALIZING ON OUR UNBUNDLED NETWORK ELEMENT PLATFORM. We provide service to a majority of our customers by leasing substantially all of the unbundled network elements from the incumbent telephone company and using our advanced back office systems to combine these elements into integrated Birch-branded voice services. This platform has allowed us to offer voice services to customers located virtually anywhere in our markets and achieve high gross margins and superior returns on incremental capital invested. The unbundled network element platform, or UNE-P, allows us to minimize current capital expenditures and maintain design flexibility for the next generation of telecommunications technology.

- POSITIONING FOR MASS DEPLOYMENT OF BROADBAND. Our network objective is to mass-deploy broadband facilities (primarily digital subscriber lines) that support both voice and data over a single line. We are implementing collocations at central offices of the incumbent telephone company throughout our markets and intend to deploy packet switches that can handle voice and data over a single line as soon as they become available.

EXPANDING OUR GEOGRAPHIC REACH

We currently serve 17 markets that have populations ranging in size from 95,000 to 4.5 million, and we intend to offer our services in 20 additional markets before the end of 2001. We expect to

expand our operations in Texas and into Oklahoma in the second quarter of this year and to commence service in the regions served by Ameritech and BellSouth in 2001. We have developed systems, network capabilities and an experienced sales force and customer service team that position us to rapidly penetrate these new markets and regions.

GROWING THROUGH ACQUISITIONS

We have completed six acquisitions since our inception in December 1996 for total consideration of $27.7 million. From time to time, we consider making additional acquisitions to further complement our service capabilities or expand our geographic scope. We believe we have been highly successful in integrating our acquisitions. With our diverse sources of capital and highly sophisticated stockholders and board members, we believe we are well positioned to continue to evaluate a variety of these opportunities and make selected acquisitions where appropriate.

TELECOMMUNICATIONS SERVICES

OFFERED SERVICES

We design our voice and data services to appeal to small and mid-sized businesses that value simple integrated communications service packages from a single provider. We believe that the key to attracting and retaining our target customers is to offer a comprehensive set of services. These services include voice offerings of local lines, features and long distance at flat per-minute rates, and data offerings including dedicated digital subscriber line and dial-up Internet access, web hosting and other data services.

We divide our service offerings generally into three broad categories: voice, Internet and web hosting. The chart below sets forth the different service packages and options provided within each of these categories.

SERVICE PACKAGES

VOICE
BIRCH BASIC A standard line
BIRCH BELLS Birch Basic with any three non-premium customer-selected features
BIRCH BELLS AND WHISTLES Birch Basic with any seven customer-selected features
VOICE MAIL Call answering, messaging and message waiting indicator Optional features include fax mail, pager notification and extension mailboxes
LINEBACKER Inside wire protection plan
MIGHTY MOUTH A two-way dedicated connection to

us, a trunk level one digital transmission link, direct inward dialing and number identification for inbound calls

INTERNET

DIAL

Unlimited Internet access, two email boxes per account, remote access to email via the Web and five megabytes of storage space plus any customer-selected features

DIAL COMPLETE

Dial plus extended period of inactivity before disconnect

ISDN COMPLETE

A dedicated integrated services digital network, an on-premise integrated service digital network router, up to 25 email boxes, dedicated Internet protocol addresses for public applications, network address translation, custom domain services, plus any customer-selected features

DSL COMPLETE

A symmetric digital subscriber line service, an on-premise router, up to 100 email boxes, Internet protocol addresses for public applications, network address translation, custom domain services, plus any customer-selected features

T1 COMPLETE

A two-way dedicated connection to us, an on-premise router, up to 100 email boxes, Internet protocol addresses for public applications, network address translation, custom domain services, plus any customer-selected features

THE INTEGRATOR

A two-way dedicated connection to us, an on-premise integrated router for voice and data, customer selection of voice and data channels to a maximum of 48, selected voice features, up to 50 email boxes, Internet protocol addresses for public applications, network address translation, custom domain services, plus any customer-selected features

WEB HOSTING

SPACE GENIE

Space Genie web-building tool, 10 megabytes of storage, 1,000 megabytes of monthly traffic,

online account status report, site submission to major search engines, custom domain services, 10 email addresses, autoresponders, autoforwarders and web-based management of email tools plus any customer-selected features

SPACE CADET

Space Genie plus 20 additional megabytes of storage, 1,000 additional megabytes of monthly traffic, common gateway interface binary access, and script library, web-based management of common gateway interface script auto-install and statistics plus any customer-selected features Additional optional features include encryption services support for real audio/video and support for Microsoft FrontPage extensions

SPACE HOG

Space Cadet plus an additional 45 megabytes of storage, 3,000 megabytes of monthly traffic, 10 email addresses, autoresponders and autoforwarders and support for real audio/video

DELIVERY OF SERVICES

UNE-P

We lease all of the unbundled network elements necessary to provide service from the incumbent local exchange carriers. We believe that our UNE-P strategy allows us to enter into new markets more quickly than if we had initially deployed our own network facilities. This strategy also reduces initial capital requirements in each market, allowing us to focus our capital resources initially on the critical areas of sales, marketing and operations support systems. In addition, we believe UNE-P will allow us to avoid further deploying circuit switches and maintain design flexibility for the next generation of telecommunications technology.

BROADBAND

We intend to install digital subscriber line equipment at our collocation sites, at our switch sites and at our customers' locations. We believe this equipment will allow us to deliver multiple voice calls and data traffic over a single, standard telephone line and is expected to provide us with substantial cost savings. Using DSL technology, we believe we will increase the amount of information we carry on a standard telephone line, which we refer to as bandwidth, to up to 1.5 million bits per second. The bandwidth is the equivalent of 24 regular voice telephone lines. Our digital subscriber line equipment will be programmed to allocate the available bandwidth.

We believe this technology will reduce our costs since we will lease a reduced number of standard telephone lines per customer from the incumbent carrier. For example, if a customer today has eight voice lines, we must order from and provision through the incumbent carrier eight individual standard telephone lines. If the same customer were to buy our service which uses digital subscriber line technology, we would only order and provision one standard telephone line from the incumbent carrier. Also, we expect that future products

and services designed to take advantage of the increased bandwidth provided by digital subscriber line technology will allow us to generate incremental revenue with attractive margins.

CUSTOMER PREMISES EQUIPMENT

We offer our customers equipment they need to run their internal phone systems, including data routers and wiring, telephone equipment and integrated access devices. We also sell and service standard key systems, private branch exchanges and voice-mail systems, and provide inside-wire services for commercial accounts, including wiring for data networking, in Kansas and Missouri. We are an authorized equipment distributor for Northern Telecom, Inc., Toshiba America Information Systems, Inc., NEC America, Inc., Executone Information Systems, Inc. and Tadiran Electronic Industries, Inc.

SALES AND MARKETING

SALES

As of March 23, 2000, we had a direct sales force of 170 representatives operating from 23 offices throughout Missouri, Kansas and Texas. Of these representatives, 28 were primarily selling customer premises equipment and the remaining 142 were selling local, long-distance, data and Internet services. The sales representatives are supported by sales managers. Over the next 12 months, we plan to increase our sales staff in existing markets and open additional sales offices in Texas and Oklahoma and in Ameritech's and BellSouth's regions. We supplement our sales efforts through brand awareness efforts including local and regional advertising, public relations and local sponsorships.

We seek to convert small to mid-sized business customers from the incumbent provider of telecommunications services in their market and to establish a solid, long-term relationship with them.

Our sales representatives meet with prospective customers to gain a thorough understanding of their business and telecommunications requirements. Sales representatives then suggest alternatives for operation enhancements and cost savings based on our service packages.

We compensate our sales representatives with a competitive base salary, stock options and commissions based on sales results. We use a revenue-based commission structure that enables us to attract productive sales people experienced in disciplined, activity-based sales. This commission structure is based on incremental revenue and is not subject to a cap.

We do not actively market to residential customers. Nonetheless, we have found that our sales and promotional efforts attract residential customers, many of whom are owners or employees of businesses using our telecommunication services. Residential customers call our customer service center to receive forms to apply for service. We do not pay sales commissions for residential sales.

ADVERTISING AND PROMOTION

We conduct extensive marketing campaigns in our local markets. We make use of advertising and public relations to attract small to mid-sized business customers and contrast our service attributes with Southwestern Bell's. Our marketing campaign includes billboard, radio and print advertising, as well as sponsorship of major local events, affiliations with local organizations and direct mailings focusing on public relations. We also believe that our willingness to serve residential customers--unlike many other competitive local exchange carriers--creates greater interest in our development among the news media and general public. In the past, our market launches have attracted extensive local media coverage.

In keeping with our philosophy of being accessible to our customers, we

establish local sales and customer service offices in most of the cities and towns that we serve. In many of these cities and towns, we are the only provider of local telephone service that maintains an office. Our offices are open to walk-in traffic and often are located in high-profile areas.

Because we are able to deliver a comprehensive set of products to our target customers, we believe we have strong customer loyalty. Our customer churn rates have generally been less than 1.5% per month.

PRICING

We do not intend to position ourselves as the cheapest provider of services, especially long distance services. We target customers who value the convenience of our service offerings and personalized customer service. Customers who have the highest price sensitivity are likely to move frequently among providers, driving up churn rates. However, we do set our pricing so that our local business customers can generally save from 10% to 40% on the incumbent provider's rates. Internet, long distance and customer premises equipment are generally priced at rates competitive with that of other service providers.

OUR MARKETS

The following chart sets forth the markets in which we provide service or expect to provide service by May 2000.

MARKET	ESTIMATED POPULATION*	INITIAL SERVICE DATE	BIRCH LINES IN SERVICE AS OF FEBRUARY 29, 2000
St. Joseph, Missouri	97,111	March 1998	2,402
Topeka, Kansas	164,932	May 1998	9,720
Wichita, Kansas	530,508	May 1998	9,098
Kansas City, Missouri	1,709,273	May 1998	25,176
St. Louis, Missouri	2,557,806	May 1998	17,125
Beaumont, Texas	374,991	May 1999	3,824
Fort Worth, Texas	1,404,904	May 1999	8,202
Longview/Marshall, Texas	208,250	May 1999	742
Tyler, Texas	166,723	May 1999	2,017
Waco, Texas	202,983	May 1999	3,565
Houston, Texas	4,320,041	June 1999	7,985
Austin, Texas	1,071,023	July 1999	4,520
Corpus Christi, Texas	387,100	July 1999	2,888
Lubbock, Texas	230,672	August 1999	2,705
Dallas, Texas	3,278,109	February 2000	1,834
San Antonio, Texas	1,511,386	February 2000	341
Amarillo, Texas	208,165	March 2000	125
Midland/Odessa, Texas	243,389	April 2000	258
Wichita Falls, Texas	137,103	April 2000	19
Abilene, Texas	121,456	May 2000	54
El Paso, Texas	701,576	May 2000	31
Other	N/A	N/A	32,374

* Population data derived from the United States Bureau of the Census, State and Metropolitan Areas datebook 1997 to 1998.

BACK OFFICE SYSTEMS

Back office systems refer to the hardware and software systems that support the primary functions of our operations, including:

- order entry and provisioning;

- billing;

- data center;

- trouble management; and

- sales support.

Our goal is to have a back office that allows us to convert our customers' service from their current local providers to our networks easily and quickly. Over time, we strive to have "flow through" provisioning capabilities, allowing services to be implemented through a single systems interface that updates all ordering, inventory, billing and monitoring systems.

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We have implemented the primary elements of our back office, including order entry, provisioning, billing and network management. We believe we have selected the best application for each function. The following table describes our key back office systems that provide crucial operational functionality, their purpose and timeline for implementation.

SYSTEM	PURPOSE	IN-SERVICE DATE
Southwestern Bell Verigate	electronic direct ordering and provisioning for local telephone service	Q1 1998
Saville CBP(TM)	billing	Q1 1999
MetaSolv TBS(TM)	order management inventory provisioning trouble management customer service	Q2 1999
Harris HNM(TM)	network management	Q4 1998
DSET(TM)	electronic bonding gateway to incumbent telephone company	Q2 2000 (est.)
HNC ATACS(TM)	fraud management	Q2 2000 (est.)
TBD	enhanced call record mediation	Q3 2000 (est.)
TBD	application integration middleware	Q4 2000 (est.)
TBD	customer care sales force automation	Q4 2000 (est.)

ORDER ENTRY AND PROVISIONING

Order entry involves the initial loading of customer data into our information systems. Currently, our sales executives take orders and our customer care and provisioning representatives load the initial customer information into our Saville billing system and our MetaSolv provisioning system. We intend to increase the efficiency and data accuracy of these provisioning activities by implementing a sales force automation system to be combined with Saville CBP and MetaSolv TBS through application integration middleware. This system will facilitate entry of sales orders from the sales offices and transmit relevant account and order information to Saville CBP and MetaSolv TBS. Implementing this system will eliminate several manual steps in the provisioning process.

We use the MetaSolv TBS-TM- system to manage and track the timely completion

of each step in the provisioning process. When MetaSolv is coupled with capabilities of the DSET electronic bonding system, we believe we will be able to submit orders to external business partners, including Southwestern Bell, electronically, thereby minimizing implementation time, coordination complexities and installation costs. Currently, we provision orders electronically through Southwestern Bell's electronic provisioning system, or Verigate.

In addition to the cost benefits associated with the electronic installation of access lines and inventory management system, the MetaSolv system improves our internal processes in various other ways, including:

- directing electronic customer orders to the appropriate employee, prompting them to complete required provisioning tasks, including network component assignments and management of outside vendor activities; and

- tracking order progress and alerting operations personnel of steps required to fulfill orders within standard work intervals.

The MetaSolv TBS system enables a customer care coordinator to keep an installation on schedule and notify the customer of any potential delays. Once an order has been completed, we update our billing system to initiate billing of installed services.

BILLING

The Saville billing system provides our customers with a consolidated invoice for all of our services. Customer calls generate billing records that are transmitted from the call records to the Saville billing system. These records are then processed by the billing software, which calculates usage costs, integrates fixed monthly charges, calculates taxation and provides the data necessary to create a simple customer invoice. We provide invoice information to a third party printer, which prepares and distributes bills to our customers. Our customers pay us directly.

This Saville system allows us to add advanced features such as special discounts based on call volume, or number of services used, complex local taxation and discrete billing options by type of service ordered. We believe these features are exceptionally important given our sophisticated client base.

TROUBLE MANAGEMENT

We use MetaSolv TBS-TM-, a customer care and trouble management system, to provide high quality customer service. Our trouble management system is integrated into the operational support system. It enables our customer care personnel to track customer problems proactively, assign repair work to the appropriate technical teams and provide employees and management access to comprehensive reports on the status of service activity.

NETWORK MANAGEMENT

We use the Harris Network Management system to continuously monitor and operate our switch networks. The information provided by the Harris system allows our network operations staff to quickly repair problems in the networks, thereby eliminating or minimizing impacts to our customers.

SOUTHWESTERN BELL VERIGATE

Verigate is the Southwestern Bell end-user interface system that allows our customer service, trouble management and service provisioning representatives to access the Southwestern Bell operating systems. Verigate allows us to send local service requests to receive order commitments back from, reserve new telephone numbers with, view an order's status at, and test or report customer problems to Southwestern Bell.

DATA CENTER

During the second quarter 2000, we plan to occupy an 8,000 square foot data center in Kansas City, Missouri. We believe this center has sufficient space to support significant increases in our access lines, customers and employees.

NETWORK FACILITIES

LEASED FACILITIES

During 1999, we began to lease substantially all of the network elements from Southwestern Bell and combine these elements into integrated Birch-branded voice services without deploying a switch. By

using UNE-P, we are able to offer our services to a broader geographical area than we can by using our own switches. Many of our competitors are limited to serving customers that are located near their facilities. UNE-P allows us to serve many customers in disparate geographic areas.

Where we have installed switches, we lease transmission facilities from Southwestern Bell to connect our switches to our collocated equipment in Southwestern Bell's central offices and to unbundled loops. Given the current capacity of existing local networks, we do not anticipate having to build local transmission facilities in the future. Similarly, we believe that the capacity of existing long-distance networks renders direct ownership of long distance transmission facilities unnecessary.

Leasing, rather than building, facilities supports our strategy of rapid local market development because our sales activity is not constrained by network expenditures. Moreover, by leasing transmission facilities, we can offer our services throughout a metropolitan area and we are not constrained by the limited number of locations in which we could build transmission facilities.

OWNED FACILITIES

We deploy data transmission packet switches in most of our markets. We use these packet switches to transmit data over our leased transmission lines and plan to use these packet switches to transmit our long distance voice traffic once our conversion plan is implemented.

We currently operate local/long distance circuit switches in Kansas City and St. Louis, Missouri and Wichita, Kansas. We do not intend to deploy more circuit switches because we believe voice-capable packet switches will be more economical to operate in the future. Additionally, we collocate our electronic equipment at Southwestern Bell's central offices to support future digital subscriber line services and existing circuit switches. Collocation allows us to connect to transmission lines we lease from Southwestern Bell.

At the customer's premises, we connect unbundled loops directly to customer-owned equipment. We may also deploy electronic equipment (intelligent channel banks or access servers) that concentrate data and voice traffic. This enables us to obtain higher capacity from the transmission line of the incumbent local exchange carrier.

OPERATIONS

EMPORIA AND KANSAS CITY SERVICE CENTERS

Our service centers in Emporia, Kansas and Kansas City, Missouri are critical to our ability to offer excellent service and to support growth. These service centers process orders, interface with Southwestern Bell's operational support systems and provide customer service, trouble resolution, billing and collection services for our customers. These service centers provide rapid, human assistance rather than the automated, cumbersome customer interface currently used by many telecommunications providers.

FIELD TECHNICAL OPERATIONS

Our field technicians service our facilities and customer-owned facilities. These technicians install, repair and maintain digital switches, transmission equipment, private branch exchanges, key systems, data equipment and inside wiring, including wiring for data networking. We believe field technicians are often the most respected source of telecommunications advice for small and mid-sized business customers. We believe that having a skilled, in-demand group of technicians supports our customer base, provides expertise for data deployment and strengthens customer loyalty.

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COMPETITION

The telecommunications industry is highly competitive. We believe we compete principally on the basis of customer service, accurate billing, variety of services and, to a lesser extent, pricing levels and less complex pricing structures. Our ability to compete effectively depends upon our continued ability to maintain high quality, market-driven services at prices generally equal to or below those charged by competitors. To maintain our competitive posture, we believe that we must be able to provide high quality integrated communications services and be positioned to reduce our prices in response to potential competition. Any of these reductions could adversely affect us. Many of our current and potential competitors have financial, technical, marketing, personnel and other resources, including brand name recognition, substantially greater than ours, as well as other competitive advantages over us.

INCUMBENT TELEPHONE COMPANIES

In our existing markets, we compete principally with Southwestern Bell. As a recent entrant in the telecommunications services industry, we may not achieve a significant market share for any of our services in our markets. In particular, Southwestern Bell and other local telephone companies have long-standing relationships with their customers, have financial, technical and marketing resources substantially greater than ours, have the potential to subsidize competitive services with revenue from a variety of businesses and currently benefit from existing regulations that favor these incumbent local exchange carriers over us in some respects. While recent regulatory initiatives, which allow competitive local exchange carriers such as us to interconnect with incumbent local exchange carrier facilities, provide increased business opportunities for us, these interconnection opportunities have been, and likely will continue to be, accompanied by increased pricing flexibility for and relaxation of regulatory oversight of the incumbent local exchange carriers. Future regulatory decisions could grant incumbent local exchange carriers increased pricing flexibility or other regulatory relief. These initiatives could also have a material adverse effect on us.

COMPETITIVE LOCAL EXCHANGE CARRIERS/INTEREXCHANGE CARRIERS/OTHER MARKET ENTRANTS

We also face competition from other current and potential market entrants. These market entrants include long distance carriers that compete with our long distance services and seek to enter, reenter or expand into the local exchange market. AT&T, GTE, MCI WorldCom and Sprint are among these carriers. Competitive local exchange carriers, resellers of local exchange services, competitive access providers, cable television companies, electric utilities, microwave carriers, wireless telephone system operators and private networks built by large end users also compete with us. In addition, consolidation and strategic alliances within the telecommunications industry, or the development of new technologies could put us at a competitive disadvantage. Not only does the Telecommunications Act impose regulatory requirements on all local telecomunications service providers, but it also grants the FCC expanded authority to reduce the level of regulation applicable to any telecommunications service provider, including any incumbent telecommunications service providers. The manner in which these provisions of the Telecommunications Act are

implemented and enforced could have a material adverse effect on our ability to compete successfully against incumbent local exchange carriers and other telecommunications service providers.

The changes in the Telecommunications Act radically altered the market opportunity for new telecommunications service providers. Because the Telecommunications Act requires local exchange carriers to unbundle their networks, new telecommunications service providers are able to rapidly enter the market by installing switches and leasing trunk and loop capacity. Newer providers, like us and some competitors that we may encounter in some of our markets, will not have to replicate existing facilities until traffic volume justifies building them, and can be more opportunistic in designing and implementing networks.

In addition to the new telecommunications service providers, interexchange carriers and other competitors listed above, we may face competition from other market entrants such as electric utilities, cable television companies and wireless companies. Electric utilities have existing assets and low cost access to capital which could allow them to enter a market rapidly and accelerate network development. Cable television companies are entering the telecommunications market by upgrading their networks with fiber optics and installing facilities to provide fully interactive transmission of broadband voice, video and data communications. Finally, wireless companies intend to develop wireless technology for deployment in the United States as a broadband substitute for traditional wireline local telephones. Some Internet companies are also developing applications to deliver switched voice communications over the Internet.

LONG DISTANCE SERVICES

The long distance telecommunications industry has numerous entities competing for the same customers and a high churn rate, as customers frequently change long distance providers in response to offerings of lower rates or promotional incentives. Prices in the long distance market have declined significantly in recent years and are expected to continue to decline. Our primary competitors are the major interexchange carriers and resellers of long distance services. We believe that pricing levels are a principal competitive factor in providing long distance service; however, we seek to avoid direct price competition by packaging long distance service, local service, customer premises equipment and Internet access service together with a simple pricing plan.

CUSTOMER PREMISES EQUIPMENT

We compete with numerous equipment vendors and installers and telecommunications management companies for the sale of customer premises equipment and related services. We generally offer our products at prices consistent with other providers and differentiate our service through our product packages.

DATA/INTERNET SERVICES

The Internet services market is highly competitive, and we expect that competition will continue to intensify. Internet service, meaning both Internet access and on-line content services, is provided by Internet service providers, satellite-based companies, long distance carriers and cable television companies. Many of these companies provide direct access to the Internet and a variety of supporting services to businesses and individuals. In addition, many of these companies, such as America Online, Inc., MSN, Prodigy Services Company and WebTV Networks, offer on-line content services consisting of access to closed, proprietary information networks. Long distance companies, among others, are aggressively entering the Internet access markets. Long distance carriers have substantial transmission capabilities, traditionally carry data to large numbers of customers and have an established billing system infrastructure that permits them to add new services. Satellite companies are offering broadband

access to the Internet from desktop PCs. Cable companies are starting to provide Internet services using cable modems to customers in major markets. Many of these competitors have substantially greater financial, technological, marketing, personnel, name-brand recognition and other resources than those available to us.

EMPLOYEES

At December 31, 1999, we employed 935 persons. Additionally, we occasionally hire temporary employees. We are not party to any collective bargaining arrangements and believe that our relationship with our employees is good.

REGULATION

REGULATORY OVERVIEW

We are subject to regulation by federal, state and local government agencies. Historically, the FCC had jurisdiction over interstate long distance services and international services, while state regulatory commissions had jurisdiction over local and intrastate long distance services.

In 1996, Congress passed the Telecommunications Act of 1996, opening the local market to competition and allowing the Bell operating companies to compete for the first time in the long distance market within their local service regions once specified conditions were met. The Telecommunications Act fundamentally changed the way telecommunications is regulated in this country. The FCC was given a major role in writing and enforcing the rules under which new competitors could compete in the local marketplace. Those rules, coupled with additional rules and decisions promulgated by the various state regulatory commissions, form the core of the regulatory framework under which we operate in providing local exchange service.

With a few limited exceptions, the FCC continues to retain exclusive jurisdiction over our provision of interstate and international long distance service, and the state regulatory commissions regulate our provision of intrastate local and long distance service. Additionally, municipalities and other local government agencies may regulate limited aspects of our business, such as use of government-owned rights-of-way, and may require permits such as zoning approvals and building permits.

In the aftermath of the Telecommunications Act, the regulation of the telecommunications industry has been in a state of flux. The FCC and state regulatory commissions have adopted many new rules to implement this legislation and encourage competition, but that implementation is ongoing. The following summary of regulatory developments does not purport to describe all current and proposed federal, state and local regulations and legislation affecting the telecommunications industry. Many of these are currently the subject of judicial proceedings, legislative hearings and administrative proposals, any of which could change, in varying degrees, the manner in which this industry operates. We cannot predict at this time the outcome of these proceedings or their impact upon the telecommunications industry or on us.

THE TELECOMMUNICATIONS ACT

THE TELECOMMUNICATIONS ACT'S LOCAL COMPETITION FRAMEWORK

One of the key goals of the Telecommunications Act is to encourage competition in local telephone service. To do this, the Telecommunications Act provides three means by which telecommunications service providers can enter the local phone service marketplace. The three modes of entry are as follows:

- RESALE. Incumbent telephone companies are required to permit new telecommunications service providers to purchase their services for resale to the public at a wholesale rate that is less than the rate charged by the incumbent telephone companies to their retail customers.

- ACCESS TO NETWORK ELEMENTS. Incumbent telephone companies are required to lease to new telecommunications service providers the various elements in their network that are used to provide local telephone service. The leased parts of the incumbent telephone companies' networks are known as unbundled network elements. The incumbent telephone companies must make unbundled network elements available at rates that are based on their forward-looking economic costs.

- CONSTRUCTION OF NEW FACILITIES. New telecommunications service providers may also enter the local phone service market by building entirely new facilities. The incumbent telephone companies are required to allow new telecommunications service providers to interconnect their

facilities with the incumbent telephone company's, so each carrier's customers can reach the other's.

To facilitate new telecommunications service providers' entry into local telephone markets using one or more or some combination of these three methods, the Telecommunications Act imposes on incumbent telephone companies the obligation to open their networks and markets to competition. When requested by competitors, incumbent telephone companies are required to negotiate, in good faith, agreements that lay out terms governing the interconnection of their network, access to unbundled network elements and resale. Incumbent telephone companies must also allow competing carriers to "collocate," or place their own equipment in incumbents' central offices.

In addition, all local exchange carriers, including both incumbent and new telecommunications service providers, are subject to the following requirements:

- INTERCONNECTION. All local telecommunications service providers must permit their competitors to interconnect with their facilities either directly or indirectly. Incumbent telephone companies are additionally obligated to permit interconnection at any technically feasible point within their networks, on nondiscriminatory terms, at prices based on cost (which may include a reasonable profit);

- NUMBER PORTABILITY. All local telecommunications service providers must implement number portability technology that allows a customer to retain its existing phone number if it switches from one local exchange carrier to a competitor. This technology primarily benefits new telecommunications service providers, which can gather market share more easily if customers can switch to these carriers without changing telephone numbers;

- RECIPROCAL COMPENSATION. All local telecommunications service providers must complete local calls originated by other telecommunications service providers under reciprocal compensation arrangements. That is, the local provider terminating a local call is entitled to payment from the local provider originating a call. Charges assessed by the incumbent telephone company for terminating calls originated on a new telecommunications service provider's network must be based on a reasonable approximation of additional cost. The FCC recently determined that Internet service provider-bound traffic is interstate in nature, not local, and is therefore outside the scope of the Telecommunications Act's reciprocal compensation provisions. The FCC has initiated a proceeding to determine appropriate carrier-to-carrier compensation for Internet service provider-bound traffic. At the same time, the FCC has declined to overturn a multitude of state decisions requiring incumbent telephone companies to pay new telecommunications service providers compensation for delivering Internet traffic to Internet service providers that had selected a new telecommunications service provider as their local service provider. The FCC's decision is on appeal, and incumbent telephone companies are also expected to ask states or federal courts to reverse the existing state determinations;

- DIALING PARITY. Requires all local telecommunications service providers to provide nondiscriminatory access to telephone numbers, operator services, directory assistance and directory listing with no unreasonable dialing delays. Local dialing parity ensures that customers on one local exchange carrier do not have to dial extra digits to reach customers on a different local or toll carrier's network; and

- ACCESS TO RIGHTS-OF-WAY. Requires all local telecommunications service providers to permit competing providers access to poles, ducts, conduits and rights-of-way at reasonable and nondiscriminatory rates, terms and conditions. The FCC has opened a proceeding seeking to define in greater detail the scope of the incumbent telephone company's obligation to provide access to rights-of-way that it owns or controls, including those within its own central offices and other buildings, and buildings owned by private third parties.

Executing an interconnection agreement does not guarantee a new telecommunications service provider unfettered access to the incumbent telephone company's market. Interconnection agreements between incumbent telephone companies and new telecommunications service providers may have short terms, requiring the new telecommunications service provider to renegotiate the agreements on a regular basis. Incumbent telephone companies may not provide timely provisioning or adequate service quality, thereby impairing a new telecommunications service provider's reputation with customers who can easily switch back to the incumbent telephone company. In addition, the prices set in the agreements or through state regulatory commission arbitration proceedings may be subject to changes mandated by state regulatory commissions as they develop permanent rules governing interconnection and may not in all instances be set at levels that allow new telecommunications service providers to compete effectively.

THE FCC'S RULES IMPLEMENTING THE TELECOMMUNICATIONS ACT'S LOCAL COMPETITION PROVISIONS

In August 1996, the FCC issued an order implementing the local competition provisions of the Telecommunications Act. The FCC established rules about how interconnection and collocation were to be provided, put forth a method that state commissions should use to establish prices for interconnection and unbundled network elements, and specified which parts of an incumbent's network must be made available as unbundled network elements to competing carriers. The FCC also held that incumbent telephone companies must provide new telecommunications service providers with "combinations" of unbundled network elements, making it possible for new telecommunications service providers, in many instances, to provide service to customers by leasing all of the component unbundled network elements from the incumbent telephone company. This method of providing service is known as the unbundled network element platform, or UNE-P. Specifically, among other rules, the FCC established a list of seven network elements, comprising most of the significant facilities, features, functionalities or capabilities of the network, that the incumbent telephone companies must unbundle. In addition, the FCC mandated a particular forward-looking pricing methodology for these network elements that produces relatively low element prices that are favorable to competitors.

After the FCC released its rules, numerous parties challenged the rules before the United States Court of Appeals for the Eighth Circuit. The Eighth Circuit overturned many of the FCC's rules on the grounds that the agency had exceeded its authority and misinterpreted the law.

On January 25, 1999, the United States Supreme Court largely reversed the Eighth Circuit's decision, holding that the FCC has general jurisdiction to implement the local competition provisions of the Telecommunications Act and reestablishing the validity of many of the FCC's interconnection rules. In so doing, the Supreme Court stated that the FCC has authority to set pricing guidelines for unbundled network elements, to prevent incumbent telephone companies from separating existing combinations of network elements, and to

establish "pick and choose" rules regarding interconnection agreements. "Pick and choose" rules would permit a carrier seeking interconnection to pick and choose among the terms of service from other interconnection agreements between the incumbent and various new telecommunications service providers.

Although it upheld the FCC's jurisdiction to establish unbundled network element pricing guidelines, the Supreme Court did not evaluate the specific "forward-looking" pricing methodology adopted by the FCC, and the case has been remanded to the Eighth Circuit for further consideration of that specific pricing methodology. Some incumbent telephone companies have argued that this pricing methodology does not allow adequate compensation for the provision of unbundled network elements. The Eighth Circuit heard oral arguments on this pricing issue on September 16, 1999, but has not yet issued a ruling. We cannot predict the outcome of this proceeding. If the Eighth Circuit fails to uphold the FCC's forward-looking pricing methodology, it may materially adversely affect our business.

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Additionally, the Supreme Court vacated the FCC rules defining what network elements must be unbundled and made available to the new telecommunications service providers by the incumbents. The Supreme Court held that the FCC must provide a stronger rationale to support the degree of unbundling ordered.

On November 5, 1999, in response to the Supreme Court's ruling, the FCC released new rules specifying which portions of the incumbent telephone companies' networks must be made available as unbundled network elements. The FCC reaffirmed that incumbent telephone companies must provide unbundled access to the following six network elements:

- loops, including loops used to provide high-capacity and advanced telecommunications services such as digital subscriber lines;

- network interface devices;

- local circuit switching;

- dedicated and shared transport;

- signaling and call-related databases; and

- operations support systems.

The FCC removed from the list of unbundled network elements operator service and directory assistance. The FCC concluded that the market has developed sufficiently that new telecommunications service providers can and do self-provide these services, or acquire them from alternative sources. The FCC also noted that incumbent telephone companies remain obligated under the non-discrimination requirements of the Communications Act of 1934 to comply with the reasonable request of a new telecommunications service provider that purchases these services from the incumbent telephone companies to rebrand or unbrand those services, and to provide directory assistance listings and updates in daily electronic batch files. In addition, the competitive checklist contained in section 271 of the Communications Act of 1934 requires Bell operating companies to provide nondiscriminatory access to these services.

The FCC also modified the local switching unbundled network element, concluding that incumbents need not provide access to unbundled local circuit switching for customers with four or more lines that are located in the densest parts of the top 50 metropolitan statistical areas so long as the incumbent makes available an alternative arrangement for reaching customers, known as the enhanced extended link. The enhanced extended link allows new telecommunications service providers to gain access to customers without collocating in every central office, because it combines the local loop with a multiplexer and transport to the new telecommunications service provider's local existing collocated facilities or switch. Notwithstanding the FCC's ruling, unrestricted access to unbundled switching is available in Texas, where state rulings require

incumbent telephone companies to make switching available as an unbundled network element.

In addition to these changes, the FCC also:

- Limited the scope of the shared transport unbundled network element, holding that the incumbent must only offer shared transport as a unbundled network element where unbundled local circuit switching is provided.

- Held that incumbents are not required to offer packet switching as a unbundled network element in most cases.

- Held that both the loop and transport unbundled network elements include access to "dark fiber." Dark fiber is distinguished from "lit fiber" transmission capacity in that dark fiber is sold independently from the electronics necessary to "light" the fiber and transmit information. The

availability of dark fiber from incumbents as a unbundled network element could create an additional source of dark fiber in the market.

- Ordered "sub-loop unbundling," which will allow new telecommunications service providers to connect at any feasible point along the local loop, and not just at the central office. In some incumbent networks, subloop unbundling will make it easier for new telecommunications service providers to use portions of the unbundled network element loop to offer advanced services, such as digital subscriber lines. In a separate order, the FCC also ordered the unbundling of the "high-frequency" portion of the loop, which also makes it easier and less expensive for new telecommunications service providers to use unbundled network elements to offer advanced services, such as digital subscriber lines.

The FCC's decision regarding unbundled network elements is currently the subject of petitions for reconsideration filed at the FCC by various parties, including us. Some incumbent telephone companies have asked the FCC to expand the limitation on switching by, among other things, extending its geographic scope. We and other new telecommunications service providers have asked the FCC to either do away with the limitation or make it applicable to only larger customers. We cannot predict the outcome of this proceeding. If the FCC further restricts the availability of unbundled switching, it could adversely affect our ability to serve customers efficiently.

Another open question is whether incumbent telephone companies are required to combine network elements not currently combined in their networks for requesting new telecommunications service providers. The FCC's rules requiring the incumbent telephone companies to do so were vacated by the Eighth Circuit, but the FCC and the new telecommunications service provider industry have asked that court to reinstate the rules in the wake of the Supreme Court's decision. If the rules are reinstated, it will significantly expand the ability of new telecommunications service providers to provide service to customers using network elements purchased from the incumbent telephone companies. Also unsettled is the scope of the FCC's rule requiring incumbent telephone companies to provide requesting new telecommunications service providers with combinations of network elements that are "currently combined" in the incumbent telephone company's network. The new telecommunications service provider industry has taken a broad view of this requirement, interpreting it to mean that new telecommunications service providers are entitled to purchase network element combinations so long as they are combined anywhere in the incumbent telephone company's network. The incumbent telephone companies, by contrast, have taken a much narrower view, arguing that the rule requires the incumbent telephone companies only to provide combinations of network elements that are currently in service to a particular customer. The ultimate resolution of this question could expand or restrict our ability to provide service to our customers using network elements purchased from the incumbent telephone company.

The Eighth Circuit is expected to rule on the pricing issue in the next

several months and may also rule on the incumbent telephone companies' obligation to provide new network element combinations in the same decision. It is not clear when the FCC or the courts will act to define the scope of "currently combined." The possible impact of the resolution of these open issues on existing interconnection agreements between incumbent telephone companies and new telecommunications service providers or on agreements that may be negotiated in the future cannot be determined at this time.

In addition to its rulings regarding interconnection and unbundled network elements, the FCC has issued a series of orders on the ability of new telecommunications service providers to provide digital subscriber lines and other high-bandwidth services to their customers for, among other things, Internet access. Those orders have made clear that new telecommunications service providers are entitled to collocate the equipment necessary to provide those services in incumbent telephone companies' central offices; that incumbent telephone companies must, where technically feasible, provide new

telecommunications service providers with high-quality loops capable of supporting digital subscriber lines and that the incumbent telephone companies must provide new telecommunications service providers with information concerning the make-up of their networks to allow the new telecommunications service provider to determine if a particular customer can be served with digital subscriber line service. However, many of the details of the orders' implementation are unsettled and we cannot assure you that the rules are sufficient to ensure that the incumbent telephone companies meet their obligations.

THE STATES' ROLE IN IMPLEMENTING THE LOCAL COMPETITION PROVISIONS

Although the FCC establishes nationwide guidelines governing entry by new telecommunications service providers under the Telecommunications Act, state regulatory commissions also have major roles in implementing the local competition provisions of the act. Among other things, state regulatory commissions must approve or reject interconnection agreements, and they have chief responsibility for arbitrating and mediating these agreements if the negotiating carriers cannot reach an understanding on the agreement's terms. State regulatory commissions are also charged with developing and implementing cost-based prices for interconnection and unbundled network elements, in accordance with the Telecommunications Act and the forward-looking pricing guidelines set by the FCC. State regulatory commissions are also permitted to establish additional unbundled network elements consistent with federal law and policy.

BELL OPERATING COMPANIES ENTRY INTO LONG DISTANCE

The Telecommunications Act also seeks to encourage local competition by requiring the regional Bell operating companies to demonstrate on a state-by-state basis that they have adequately opened their network and market to competitors before they can provide long distance service to end users in their own local service areas. Specifically, the Telecommunications Act lays out a 14-point checklist which generally requires a regional Bell operating company to prove to the FCC that it has complied with the interconnection and network access obligations discussed above and that it faces effective competition in the state where it seeks to provide long distance service. While the FCC has ultimate responsibility for deciding whether the checklist conditions have been met, the FCC is required to first consult with the appropriate state regulatory commission.

Southwestern Bell is in the process of applying for authority to provide long distance service in Texas. The FCC is expected to rule on Southwestern Bell's application in April 2000. Southwestern Bell has also begun the process of applying for long distance authority in Kansas by making a preliminary filing with the Kansas state regulatory commission. If Southwestern Bell receives approval from the FCC as described above, Southwestern Bell will be able to provide in-region long distance services, which will enable it to provide

customers with a full range of local and long distance telecommunications services. The ability of Southwestern Bell to provide long distance services is expected to be an additional source of competition for us.

OTHER FEDERAL REGULATION

The FCC regulates our interstate and international service offerings. Those services include our provision of interstate and international long distance service and our provision of interstate access service. The FCC has established different levels of regulation for dominant carriers and non-dominant carriers. Incumbent telephone companies, such as the Bell operating companies and GTE, are currently considered dominant carriers, and are subject to extensive rate and operational regulation, while new telecommunications service providers such as we are considered non-dominant carriers, and are subject to substantially less regulation.

INTERSTATE AND INTERNATIONAL LONG DISTANCE SERVICES

Interstate and international long distance services of non-dominant carriers are subject to relatively little regulation by the FCC. Our provision of international long distance services requires prior authorization by the FCC under Section 214 of the Telecommunications Act, which we have obtained. We are also required to file tariffs with the FCC for international long distance service on an ongoing basis.

Under the FCC's streamlined regulation of non-dominant carriers, we may install and operate facilities for the transmission of domestic interstate communications without prior FCC authorization.

In addition, in October 1996, the FCC adopted an order in which it eliminated the requirements that non-dominant interstate interexchange carriers maintain tariffs on file with the FCC for domestic interstate services. The order does not apply to the switched and special access services of the Bell operating companies or other local exchange carriers. The FCC order was issued under authority granted to the FCC in the 1996 Act to "forbear" from regulating any telecommunications services provider under some circumstances. After a nine-month transition period, relationships between interstate carriers and their customers would be set by contract. At that point, long distance companies would be prohibited from filing tariffs with the FCC for interstate, domestic, interexchange services. Several parties filed notices for reconsideration of the FCC order and other parties appealed the decision. On February 13, 1997, the United States Court of Appeals for the District of Columbia Circuit stayed the implementation of the FCC order pending its review of the order on its merits. Currently, that stay remains in effect and interstate long distance telephone companies are therefore still required to file tariffs.

The D.C. Circuit heard oral argument on the merits of the FCC's detariffing order on March 14, 2000, but has not yet issued an order. If the stay is lifted and the FCC order becomes effective, telecommunications carriers will no longer be able to rely on the filing of tariffs with the FCC as a means of providing notice to customers of prices, terms and conditions on which they offer their interstate services. The FCC has required that non-dominant interexchange carriers post their rates, terms and conditions for all their interstate, domestic services on their Internet web sites if they have one; this rule is effective once the FCC's mandatory detariffing order takes effect. This may result in significant administrative expenses for us. The obligation to provide non-discriminatory, just and reasonable prices remains unchanged under the Communications Act of 1934. Tariffs also allow a carrier to limit its liability to its customers, including in connection with service interruptions. If tariffs are eliminated, we may become liable for costs that we would have been able to limit through tariff filings, and we cannot assure you that the potential liabilities will not have a material adverse effect on our results of operations and financial condition.

ACCESS SERVICES

Unlike dominant carriers, which are subject to extensive rate regulation, we and other non-dominant carriers are subject to relatively little regulation of our interstate access services. The FCC has eliminated the requirement that non-dominant carriers must file tariffs for their access services. While no longer mandatory, carriers may continue to file access tariffs. We have chosen to continue to do so.

In August 1999, the FCC granted incumbent telephone companies subject to price cap rate regulation, including the regional Bell operating companies, substantial pricing flexibility with regard to some interstate access services. Among other things, the FCC's new rules permit incumbent telephone companies, upon a showing that the services in question are subject to sufficient levels of competition, to offer volume and term discounts and contract tariffs for particular access services. The new rules also allow incumbent telephone companies, upon meeting a higher competitive standard, to file tariffs for their access services free from many rate structure requirements. To the extent these regulatory

initiatives enable or require incumbent telephone companies to offer selectively reduced rates for some access services, the rates we may charge for these access services will likely be constrained. In addition, the FCC has recently initiated a proceeding to examine whether to regulate the rates that new telecommunications service providers charge for their access services. While the FCC has received considerable opposition from the new telecommunications service provider industry and others to doing so, we cannot assure you that the FCC will not adopt some form of regulation for new telecommunications service provider access charges. The timing of the FCC's decision is uncertain.

In addition to the pricing flexibility described above, the FCC is currently considering a joint proposal from AT&T, Bell Atlantic, BellSouth, GTE, SBC Communications and Sprint to lower significantly and deleverage interstate access charges for participating price cap local exchange carriers. The FCC could issue an order on this proposal in the first half of 2000. If adopted, these pricing reforms could increase competition among carriers offering local exchange and exchange access service in our operating area.

ADDITIONAL FEDERAL ISSUES

ACCESS TO POLES, DUCTS, CONDUITS AND RIGHTS-OF-WAY. An area of the law that remains in flux concerns the extent of a carrier's obligations to provide access to poles, ducts, conduits and rights-of-way. We are obligated under Section 224 of the Communications Act to permit other carriers reasonable access to our poles, ducts, conduits and rights-of-way and the FCC has adopted comprehensive rules governing how access is to be provided. The FCC is also currently considering additional rules, including whether access to rooftops and space inside buildings, including buildings owned by utilities, should be mandated under the Telecommunications Act.

EEO REPORT. The FCC requires us to file an annual employment report to comply with the FCC's equal employment opportunity policies.

TRUTH IN BILLING. The FCC has adopted new rules designed to make it easier for customers to understand the bills of telecommunications carriers. These new rules establish requirements regarding the formatting of bills and the information that must be included on bills. These rules have been appealed in federal court.

ANTI-SLAMMING RULES. The FCC implemented the so-called "anti-slamming" rules, which protect consumers whose pre-subscribed carriers have been switched without their consent. Under the rules, a carrier found to have slammed a customer is subject to substantial fines and must remove from the consumer's bill all charges incurred within 30 days of the slamming. While we do not engage in these practices, a slamming fine, if levied, could have a material impact on our business in the future.

CUSTOMER PROPRIETARY NETWORK INFORMATION. In February 1998, the FCC adopted rules implementing Section 222 of the Communications Act of 1934, which governs the use of customer proprietary network information by telecommunications carriers. Customer proprietary network information generally includes any information regarding a subscriber's use of a telecommunications service, where it is obtained by a carrier solely by virtue of the carrier-customer relationship. The FCC has clarified that customer proprietary network information does not include a subscriber's name, telephone number, and address, as this information is generally not derived from the carrier's provision of a telecommunications service to a customer. Under the FCC's rules, a carrier may only use a customer's proprietary network information to market services that are "necessary to, or used in," the provision of a service that the carrier already provides to the customer, unless it receives the customer's prior oral or written consent to use that information to market other services. In December 1999, the United States Court of Appeals for the Tenth Circuit vacated the FCC's original and modified customer proprietary network information rules on the grounds that they violate the First Amendment. However, Section 222 of the Communications Act remains the law and that section, in addition to the FCC's

now-vacated rules, provides some guidance on the use of customer proprietary network information rules. Uncertainty regarding restrictions on the use of customer proprietary network information rules may impede our ability to market integrated packages of services effectively and to expand existing customers' use of our services.

UNIVERSAL SERVICE. On May 8, 1997, the FCC released an order establishing a significantly expanded federal universal service subsidy regime under the Telecommunications Act. The universal service program provides support to carriers serving low-income customers and customers who live in areas where the cost of providing telecommunications services is high. In addition, the FCC established new subsidies for telecommunications and some information services provided to qualifying schools and libraries and for services provided to rural health care providers. Providers of interstate telecommunications services, as well as other entities, such as private carriers offering excess capacity to end user customers, must pay for these programs. Our contribution to the federal support funds would be calculated based on a percentage of our gross end-user interstate and international telecommunications revenues. The assessment rate for the second quarter of 2000 is 5.7101% of interstate and international end-user telecommunications revenues. The contribution factor issued by the FCC varies quarterly. The amounts contributed may be billed to customers. Currently, the FCC is calculating assessments based on the prior year's revenues. Assuming that the FCC continues to calculate contributions based on the prior year's revenues, we believe that we will not be liable to contribute any material amount to these programs during 2000 because we had limited interstate and international end user revenues in 1999. The threshold before we are required to contribute is a $10,000 contribution, which translates into roughly $175,000 in interstate end user telecommunications revenues. With respect to subsequent years, however, we are currently unable to quantify the amount of any contributions that we will be required to make or the effect that these required contributions will have on our financial condition.

The FCC has recently adopted the cost model which it will use to determine the support needed in high-cost areas and the inputs for the model. The new high-cost support mechanism, which went into effect on January 1, 2000 for non-rural carriers, substantially increases the amount of high-cost support provided to non-rural carriers. The United States Court of Appeals for the Fifth Circuit recently issued an order upholding in part, and reversing in part, the May 8th FCC order implementing these funds. Numerous FCC orders revising these funds are subject to petitions for reconsideration and further petitions for appeal. The outcome of these proceedings or their effect cannot be predicted.

In addition to the universal service mechanisms described above, the FCC is currently considering a joint proposal from Bell Atlantic, BellSouth, GTE, SBC

Communications, AT&T, and Sprint to create a $650 million fund to provide universal service support for interstate access charges. If adopted, this proposal could significantly increase the contribution obligations of other telecommunications carriers.

COMMUNICATIONS ASSISTANCE FOR LAW ENFORCEMENT ACT. Under this act, telecommunications carriers are required to: (1) provide law enforcement officials with call content and call identifying information under a valid electronic surveillance warrant, and (2) reserve a sufficient number of circuits for use by law enforcement officials in executing court authorized electronic surveillance. If we provide facilities-based services, we may incur costs in meeting both of these requirements. In particular, regarding the requirements related to call content and identification, except in very limited circumstances the government is required to compensate carriers only for the costs of making equipment installed or deployed before January 1, 1995 compliant with this act. While the telecommunications industry is attempting to negotiate legislative and administrative changes to this reimbursement cut-off date, as it stands today, we will be financially responsible for ensuring that our post-1995 equipment is in compliance. Regarding the circuit capacity requirements, the government will finance any necessary increases in capacity for equipment that we have specifically identified as installed or deployed prior to September 8, 1998, and we are responsible for paying only for any necessary increases in capacity for equipment installed or deployed after that date.

STATE AND LOCAL REGULATION

In general, state regulatory commissions have regulatory jurisdiction over us when our facilities and services are used to provide local and other intrastate services. Under the Telecommunications Act, state commissions continue to set the requirements for providers of local and intrastate services, including quality of services criteria. State regulatory commissions also can regulate the rates charged by new telecommunications service providers for intrastate and local services and can set prices for interconnection by new telecommunications service providers with the incumbent telephone company networks, in accordance with guidelines set by the FCC. In addition, state regulatory commissions in many instances have authority under state law to adopt additional regulations governing local competition, so long as the state's actions are not inconsistent with federal law or regulation.

Most state regulatory commissions require companies that wish to provide intrastate common carrier services to register or be certified to provide these services. These certifications generally require a showing that the carrier has adequate financial, managerial and technical resources to offer the proposed services in a manner consistent with the public interest. In most states, we are also required to file tariffs setting forth the terms, conditions and prices for services that are classified as intrastate, and to update or amend our tariffs as rates change or new products are added. We may also be subject to various reporting and record-keeping requirements.

We are currently certified by the Missouri Public Service Commission, the Kansas Corporation Commission, the Texas Public Utilities Commission and the Oklahoma Corporation Commission to provide both local and intrastate long distance service in those states. We have tariffs on file in each of these states.

If we choose to install our own transmission facilities, we may be required, in some cities, to obtain street opening and construction permits, permission to use rights-of-way, zoning variances and other approvals from municipal authorities. We also may be required to obtain a franchise to place facilities in public rights of way. In some areas, we may be required to pay license or franchise fees for these approvals. We cannot assure you that fees will remain at current levels, or that our competitors will face the same expenses, although the Telecommunications Act requires that any fees charged by municipalities be reasonable and non-discriminatory as among telecommunications carriers.

